IN THE

Supreme Court of the United States

October Term, 1975

No. 75-1665

CHESTNUTT CORPORATION, GEORGE A. CHESTNUTT, JR., ARNOLD JOHN CURRIE, WARREN K. GREENE and STANLEY L. SABEL,

Petitioners,

v.

ROSALIND FOGEL and GERALD FOGEL,

and

AMERICAN INVESTORS FUND, INC.,

Respondents.

BRIEF OF RESPONDENTS ROSALIND FOGEL AND GERALD FOGEL IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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The petition for certiorari asks this Court to rule upon an issue which is no longer of any importance—the recapture of excess brokerage commissions. In 1975, both Congress and the SEC abolished fixed minimum rates of commission (15 U.S.C. § 78f(e) (1)) (89 Stat. 97, 104, 107); SEC Rel. No. 34-11203). With the advent of fully negotiated commissions, recapture has become academic. Give-ups and reciprocals have also ended, as has institutional membership in stock exchanges. Moreover, the only two Circuit Courts of Appeals which have considered recapture

have agreed both on the legality of recapture and on the duty of investment company managements to fully inform their outside directors of its availability—propositions which could hardly give rise to disagreement. In short, the petition presents no issue of consequence for this Court to consider.

STATUTES AND REGULATIONS INVOLVED

In addition to the statutes referred to in the petition, we annex hereto pertinent parts of the text of § 10 of the Investment Company Act.

COUNTER-STATEMENT OF THE QUESTION PRESENTED FOR REVIEW

The question presented by petitioners is incomprehensible. Far from admitting full compliance, as petitioners contend (p. 2), respondents have consistently contended, and the Court of Appeals found, that petitioners violated the Investment Company Act. The sole question presented is whether the Court of Appeals, after careful examination of a record of thousands of pages, erred in finding that the petitioners breached their fiduciary duty to American Investors Fund, Inc. (the "Fund") by failing to inform the Fund's independent directors of the availability of recapture.

STATEMENT OF THE CASE

Jurisdiction and proceedings

In this stockholders' derivative action commenced on July 11, 1968 (1a),* the District Court's jurisdiction was

* "A" refers to the Appendix to the petition for certiorari. "a" refers to the Appendix in the Court of Appeals.

based on the Investment Company Act of 1940 (the "Act"), 15 U.S.C. § 80a-1 *et seq.* After a non-jury trial limited to the issue of liability (325a), the District Court for Southern New York (Wyatt, J.) dismissed the action (32A). The Second Circuit (per Friendly, J.) unanimously reversed and remanded the case for determination of damages (83A). That determination has not yet been made.

The parties

Plaintiffs have been shareholders of defendant American Investors Fund, Inc. (the "Fund") since 1963 (5a). The Fund is a no-load mutual fund; as of December 31, 1968 its assets were over $342,000,000 and it had 142,000 shareholders (Trial Exhibit 16).

Defendant Chestnutt Corporation ("Management Co.") is the Fund's manager and investment adviser. Under the investment advisory agreement between the Fund and Management Co., the advisory fee is a percentage of the assets of the Fund; as the Fund grows, the fee becomes larger (28a).

The stockholders of Management Co. include petitioners Chestnutt, Sabel, Greene and Currier (26a-27a).

The activities complained of in this action occurred from January 1, 1965 to the present. At all times during that period the officers and executive personnel of the Fund and Management Co. were closely interlocked. Thus, petitioner George A. Chestnutt, Jr., the founder of the Fund, was its president and director. He was also president and a director of Management Co. (27a). Petitioner Chestnutt was the principal force in both the Management Co. (where his economic interest lay) and in the Fund.

Petitioner Sabel was senior vice president, secretary and a director of the Fund. He was also vice president,

secretary, general counsel and a director of Management Co. (*id.*). Petitioner Greene was vice president and director of the Fund, and vice president of Management Co. (*id.*).

During the relevant time period, the Fund had a board consisting of eight (or, at times, seven) directors. At all times at least 50% of the Fund's directors had an economic interest in Management Co. and during much of the time more than 50% of the Fund's directors had such an interest (328a-329a).

The Fund had no independent officers. All of its officers were also stockholders, officers, directors and/or employees of Management Co. Their compensation was paid by Management Co.; the Fund paid them nothing (159a, 175a). In any conflict of interests, therefore, their allegiance was likely to be to their paymaster, Management Co., not to the Fund. All the Fund's other employees likewise received their compensation from Management Co. (*id.*).

Give-ups and reciprocals

Plaintiffs' charges arose from defendants' give-up and reciprocal practices.

The Fund bought and sold large amounts of portfolio securities on national securities exchanges, investing the pooled assets of its shareholders. These transactions were subject to the minimum commission rates formerly fixed by the exchanges. Since the Fund and other institutions frequently executed transactions of substantial size, the minimum commissions were often considerably in excess of those which would fairly compensate a broker for his services; SEC, *Public Policy Implications of Investment Company Growth*, H. Rep. No. 2337, 89th Cong., 2d Sess. pp. 162-163 (1966) ("PPI"). The brokerage commissions generated by the Fund's transactions were substantial, averaging about $2,500,000 per year (155a).

Under exchange rules, brokers were permitted to share their commissions with other brokers. Pursuant to those rules, brokers executing institutional orders would, at the direction of those placing the orders, "give up" large portions of their commissions to other brokers. So attractive was the Fund's portfolio business to brokers who executed it, that they were willing to give up a major portion of their commissions, as much as 75%, to other brokers (84a, 85a, 253a, 254a). At the behest of officers and employees of Management Co., brokers were directed to give up a portion of their commissions to other brokers who assisted in the sale of Fund shares (84a). Such give-ups continued until give-ups were abolished by the stock exchanges on December 5, 1968 (176a, 177a).

In other instances, brokers who assisted in the sale of Fund shares executed transactions themselves. As a reward for selling Fund shares, these brokers were allowed to keep all the Fund commissions they received despite the fact that they were prepared to give up a portion of those commissions at the direction of the officers and employees of Management Co. (92a-95a). This practice of rewarding brokers for selling Fund shares by giving them commission business of the Fund is commonly referred to as reciprocals. Reciprocals were utilized by the petitioners until they were abolished by the NASD on May 25, 1973, effective July 15, 1973 (Trial Exhibit 18).

Reciprocals and give-ups were also directed to brokers who supplied research information to Management Co. (176a).

These reciprocals and give-ups were of great advantage to the Management Co. Its contractual compensation depended, in large measure, on the number of Fund shares sold to the public (44a, 45a). The more Fund shares the public bought, the greater became the asset value of the

Fund, and the advisory fees received by the Management Co., which were a percentage of Fund assets managed, grew accordingly. The Management Co. thus had a vital economic interest in encouraging the sale of Fund shares.

The Fund was, nominally at least, a no-load Fund. No sales fees are supposed to be paid to brokers for sales of no-load funds (15 USC § 80a-10(d)(3)). Nevertheless, the Management Co. found it quite desirable to stimulate sales of Fund shares by brokers. In order to provide an incentive to them, the Management Co. used the Fund's portfolio brokerage commissions to reward brokers who sold Fund shares. It was petitioners' practice to award reciprocals or give-ups amounting to at least 2% of the gross sales of Fund shares produced by a particular broker (92a-95a).

Pursuant to its contract with the Fund, Management Co. was obligated to pay all the expenses relating to the promotion and sale of Fund shares (159a). To the extent these expenses were paid with Fund brokerage commissions, Management Co. was able to reduce its own expenses.

Since give-ups and reciprocals increased the advisory fees paid to Management Co. by enhancing the sale of Fund shares, they constituted tangible benefits to Management Co. These benefits to Management Co. cannot be disputed.

Indeed, at the trial defendants conceded that the growth of the Fund benefited Management Co. by increasing its advisory fees (44a-45a), and that give-ups and reciprocals were used to promote sales and thus contributed to such growth (160a, 161a).

The commissions allocated in return for research also benefited Management Co. Management Co. had the obligation under the Investment Advisory Contract to supply investment advice to the Fund. For this it was paid handsomely. By using Fund commissions to obtain research

from others, Management Co. produced the investment advice at lesser cost to itself, but at the Fund's expense.

Recapture

Recapture of brokerage commissions operated in a simple manner. Mutual funds and other institutions, in addition to paying brokerage commissions, also paid advisory fees to their investment advisers. The stock exchanges placed no minimum on such fees. It became common practice for institutions to direct commissions and give-ups to their investment advisers who would credit the commissions received against the advisory fees otherwise payable. This practice was widespread and expressly permitted by the exchanges and the courts. The exchanges regarded it as quite consistent with their rules, and the SEC found it to be a frequent and acceptable practice:

> "The use of brokerage commissions to pay for investment advisory services is common in the securities industry. Investment advisers who are also broker-dealers often reduce advisory fees charged nonfund clients by a specified portion of the brokerage commissions generated by their nonfund advisory accounts or otherwise take them into account in setting advisory fee rates for nonfund clients." PPI pp. 108-109 (143a-144a).

Nothing in this practice contravened the anti-rebate rules; for despite the reduction or even the elimination of the advisory fee, the customer still paid the prescribed minimum commission rates.

There were essentially two avenues available for the channelling of recapturable commissions: NASD membership and exchange membership. A number of regional exchanges permitted NASD members to receive brokerage

commissions in the form of give-ups or discounts (51a; PPI p. 173 (147a)). Once these commissions were received by an NASD member affiliated with a fund or its adviser, they could be credited against advisory fees, i.e., recaptured (51a-53a, 147a, 218a, 220a).

Certain regional exchanges, notably the PBW Exchange, permitted affiliates of mutual funds to become members. As an "introducing broker" (a common role in the securities business), the affiliated member did not need to execute or clear transactions (54a-55a). It could simply transmit the orders of its fund customer to other exchange members, retaining a substantial portion of the commissions paid on those transactions. Those retained commissions could also be credited against advisory fees owed by the fund (54a-58a, 65a-66a). Both of these recapture methods received express judicial sanction; *Kurach* v. *Weissman,* 49 F.R.D. 304 (S.D.N.Y. 1970); *Weiss* v. *Chalker,* 59 F.R.D. 533, 535 (S.D.N.Y. 1973); *Moses* v. *Burgin,* 445 F.2d 369 (1st Cir. 1971), *cert. denied sub nom Johnson* v. *Moses,* 404 U.S. 994.

The Management Co. defendants were fully cognizant of the possibility of recapture. They became aware of recapture practices of other funds as early as 1965 (231a, 240a). They read and considered the recapture urgings of the SEC in its 1966 PPI Report (82a, 97a, 227a), and in the SEC's 1968 Release No. 8239 (233a-236a).

The independent directors

Section 10 of the Investment Company Act requires that at least 40% of the directors of an investment company not be "affiliated persons".* Under § 10(d) of the Act, a no-

* In 1970, the statute was amended to substitute the term "interested persons" for "affiliated persons" (see 57A n.11). For convenience's sake, we use the term "independent", as did the Court of Appeals (*id.*), to refer to unaffiliated or disinterested persons.

load fund need have only one independent director. It is doubtful whether this exception was available in the present case since, through the payment of give-ups and reciprocals, the Fund incurred "sales or promotion expenses" contrary to § 10(d)(5). In any event, the Fund did, during the period in question, have at least three, and sometimes four, independent directors at all times.

Unlike the petitioners, the independent directors were, by and large, unfamiliar with the securities brokerage industry (173a). The Management Co. defendants and their counsel, Messrs. Sabel and Lee, advised the independent directors, contrary to the fact, that recapture for the Fund was impossible (268a-272a). The independent directors believed this advice (108a-110a, 118a,-121a, 249a, 321a). They never sought outside advice (121a, 246a-248a, 321a). They never knew that recapture was available without substantially changing the operations of the Fund or Management Co. Had they known this fact, they might have favored recapture (120a-121a). But, because they were misled by the petitioners, the Fund never recaptured a dime.

REASONS FOR DENYING THE WRIT

Petitioners' arguments, to the extent intelligible, proceed from the assumption that the Court of Appeals decision mandates that investment advisers become full-scale, public brokers. Nothing could be further from the mark.

As noted by the Court of Appeals (42A), the plaintiffs maintained that Management Co. should have organized an affiliate for the sole purpose of recapturing commissions. Such an affiliate would have been eligible for membership in the NASD and on the PBW Exchange, both obtainable as a ministerial matter (54a-58a, 65a-66a, 171a-172a, 208a,

210a). Recapture of commissions would have followed simply for the asking (51a-52a, 60a-63a, 218a-220a). No change in the manner of operating either the Fund or Management Co. was required, since Management Co. had long been effecting transactions for the Fund and others (73a-74a, 88a-91a, 104a-105a). As the Court below recognized, "the forms of recapture which the plaintiffs propose" did not require Management Co. to "participate in the brokerage business" (66A), nor to "be primarily engaged in public business" as "a full-fledged brokerage house." (*id.*, n.16). It was this avenue of recapture—acting as an introducing broker and "merely channel[ing] the Fund's orders to executing brokers" while recapturing up to 80% of the commissions—that the Court of Appeals held required presentation to the independent directors (73A n. 23; interpolation added).

Thus, the supposed conflict of the decision below with this Court's decision in *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180 (1963) (Pet., pp. 2, 31-32), is illusory. A recapture affiliate would not have involved the adviser in a conflict of interest. On the contrary, it would have removed Management Co.'s conflict between its duty to render impartial advice to the Fund and its desire to stimulate sales by portfolio turnover. The channeling of excess brokerage commissions back to the Fund, rather than for the benefit of Management Co., would have eliminated Management Co.'s ulterior motives in determining Fund transactions. *Capital Gains Research Bureau* is, thus, authority for respondents' position rather than petitioners', especially since it recognizes the obligations imposed upon an investment adviser by virtue of its fiduciary relationship.

Petitioners' suggested conflict with *Moses* v. *Burgin,* 445 F.2d 369 (1st Cir. 1971), *cert. denied sub nom Johnson* v. *Moses,* 404 U.S. 994 (Pet. p. 30), is also mistaken. As the

Court below noted (59A), *Moses* held that investment advisers are under a duty of full disclosure to independent directors, and, where they fail to fulfill that obligation, they are liable for failure to recapture brokerage. The Court below followed *Moses.*

Moses held that an investment adviser need not pursue membership on the New York Stock Exchange. But that was because that Exchange required its members to be primarily engaged in brokerage rather than investment counselling, and would not consider a recapture affiliate as distinct from its related adviser; 445 F.2d at 375. On the other hand, the PBW Exchange welcomed as members subsidiaries of investment advisers whose sole purpose was to recapture commissions (54a-58a, 65a-66a). The Court below was clearly correct in so finding (73A-74A), and equally correct in pointing out that the *ratio decidendi* of *Moses* imposes the same disclosure requirements where exchange membership is available as in the case of NASD recapture (78A, n.29).

After an extensive review of the record, the Court of Appeals correctly found that the petitioners had failed to advise the independent directors of the readily available recapture methods (67A-69A).* This finding is amply supported by the record (30a-31a, 268a-272a; Trial transcript, pp. 340, 380; Trial Exhibit 23, p. 23; Trial Exhibit Q, pp. 40-41). Petitioners contend that one independent director, Radcliffe, was sophisticated enough to know of the possibility of forming an affiliate for the sole purpose of recapturing commissions (Pet. pp. 16-19). The record (Trial Exhibit Q, pp. 34-35; Trial transcript, pp. 375-76) demonstrates, however, that, as the Court below found, even Radcliffe "assumed that recapture was possible only

* The district court presumably agreed, for it found that petitioners were obligated to effect recapture if they could do so (A26).

by a full-fledged brokerage house." (66A, n.16). In any event, knowledge by only one independent director out of several could hardly justify petitioners in concealing the facts from the remaining directors. The Court of Appeals so held (60A, n. 14); petitioners cite no authority controverting the self-evident reasonableness of that holding.

Petitioners, relying on a newspaper article (Pet., p. 30), predict that numerous suits will result from the Court of Appeals decision. That decision was filed December 30, 1975 (3A). We are not aware of a single recapture suit since then, and petitioners do not point to any.*

In short, the petition raises no issue worthy of this Court's consideration. The Court of Appeals' decision is eminently sound. It is consistent with the holdings of this Court and of the First Circuit. The fact findings are solidly based on an extensive record, and have no particular relevance for any other case, either pending or anticipated.

* The Court of Appeals noted that, in 1971, there had been fifty such suits (35A, n.1). Virtually all have been disposed of, mostly by settlement. We are aware of only three presently pending, aside from the instant case: *Tannenbaum* v. *Zeller,* 399 F. Supp. 945 (S.D.N.Y. 1975; appeal pending), where judgment was for defendants on the ground that they fully disclosed recapture possibilities to their independent directors; *Papilsky* v. *Berndt,* 71 Civ. 2534 (S.D.N.Y.), recently tried after this Court twice denied *certiorari* on preliminary issues (409 U.S. 1077 and 419 U.S. 1048); and *Stanley* v. *Carret,* CCH Fed. Sec. L. Rep. ¶ 92,952 (S.D.N.Y. 1971), presently in the pre-trial stage after having been transferred to the District of Massachusetts.

CONCLUSION

The petition for a writ of certiorari should be denied.

Dated: June 7, 1976

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Statutory Appendix

Section 10 of the Investment Company Act of 1940, 15 U.S.C. § 80a-10:

> (a) No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company.

*   *   *